

The Basics of Blending

by Glenn S. Daily

If your client needs cash value life insurance, which products should you put on the table? Low-load policies generally offer excellent value, so that's the first place to look. But what if the low-loads aren't available in your client's state, or it's a large case requiring more diversification, or there's an agent involved who happens to be your client's best friend? In that case, you'll need to look at commissionable policies, and you may be able to reduce the commission and improve the policy values through a process called blending.

Blending is done primarily with traditional whole life. To compete with the flexibility of universal life, most whole life vendors offer term and paid-up additions riders that can be added to a base policy. By using a combination of these components, the agent can show a lower annual outlay than would be required for whole life alone. For example, if a \$1 million whole life policy costs \$30,000 a year, the agent can reduce the annual outlay to \$20,000 by combining \$500,000 whole life and \$500,000 term and paid-up additions (PUAs). The whole life would cost about \$15,000, the first-year term charge might be \$800, and the remaining \$4,200 would buy PUAs. The term insurance is gradually replaced by PUAs purchased by rider and with annual dividends.

The agent's commission is also reduced. The whole life component will pay the usual 55% base commission plus expense allowances plus other sales incentives. The term component may pay the same total percentage, but on a much smaller amount. The PUA component will typically pay about 3%. Therefore, instead of getting at least 55% of \$30,000, the agent would get at least 55% of \$15,800, plus 3% of \$4,200.

This sets the stage for another use of blending: taking money from the agent's pocket and putting it back into the policy. Every dollar that you can shift from high-commission whole life to low-commission paid-up additions frees up at least 52 cents for your client. And that's only in the first year. There are also commission differences in subsequent years, as well as the effect of compounding.

Here's a real-life example to demonstrate how this can work in practice. My client had recently purchased a \$1 million whole life policy from a respected company. The agent had set it up as a 50/50 blend, with a total annual premium of about \$53,000. The \$500,000 whole life component cost about \$41,000, and it had no first-year cash value. The remaining \$12,000 paid for the term/PUA rider, which had a \$6,000 first-year cash value. The illustrated values are shown in the table on the next page.

Comparison of Two Blended Designs				
Policy year	50% whole life		25% whole life	
	Death benefit	Cash value	Death benefit	Cash value
1	\$1,000,000	\$6,000	\$1,000,000	\$22,000
5	1,000,000	144,000	1,000,000	185,000
10	1,000,000	333,000	1,000,000	424,000
20	1,000,000	774,000	1,298,000	1,226,000
Annual premium:				
	Whole life	\$41,000		\$20,000
	Term/PUAs	12,000		33,000
	Total	<u>\$53,000</u>		<u>\$53,000</u>

The agent had not discussed the full range of blended designs, and my client was interested to hear that a more efficient configuration was possible. After reviewing his options, he told the agent to get the policy re-issued retroactively as a blend of 25% whole life and 75% term/PUAs, with the same \$53,000 total premium. Most of the premium now goes to low-load paid-up additions, with a first-year cash value of \$22,000. Equally important, the total death benefit might eventually be at least 30% higher with the revised design, due to the internal compounding of the cost savings. These numbers are shown in the table.

This example is not unusual. Many insurance buyers do not receive the most favorable proposal, and a knowledgeable adviser can provide valuable guidance. There are several obstacles that can complicate these assignments:

- **Agent resistance.** “Blending is risky. I wouldn’t go below 50% whole life,” the agent might say. Accountants and attorneys sometimes parrot this line, because it’s an easy way to sound knowledgeable and prudent. Some agents oppose blending because they want to protect their commissions. More often, the agent simply doesn’t understand how the product is designed, and then you have to spend time providing the training that the company failed to provide. Meanwhile, the client is caught in the middle, wondering who is right.

It's certainly true that blending is risky if you don't add a paid-up additions rider on top of the whole life and term, and this can be a source of confusion. The goal is to use blending to reduce commissions and improve policy values, not to reduce the outlay.

There is one legitimate reason for agent resistance: some companies permit so much blending that the agent will receive inadequate compensation for services rendered if you use an optimal blend. The solution in those cases is to increase the commissions taken out of the policy by using a less-than-maximum blend, or to pay a separate fee.

- **Peculiar results.** Sometimes blending fails to produce the expected results, and then you have to dig behind the sales illustrations to figure out what is wrong. You may discover that blending really doesn't work with a particular product; for example, if the term rates are unreasonably high. You may discover that blending only appears not to work but actually does; for example, if the interest rate for paid-up additions is a new-money rate whereas the whole life dividends are based on a temporarily higher portfolio rate.

You may find that the blended design appears to have inferior guarantees. This shortfall may be caused by a different reserve basis for the term rider and the whole life policy or by misleading illustration software, which fails to pick up the guaranteed values of the paid-up additions rider. Blending does not produce inferior guarantees in a practical sense; on the contrary, having more money immediately available in the policy provides a cushion against future adverse changes.

- **Legitimate drawbacks.** There are a few potential drawbacks in using blending.

For second-to-die policies with a jump-up in values at the first death, blending may lead to lower long-term values if the first death occurs shortly after the policy is issued. This trade-off should be discussed with the client, although it can be time consuming to get the appropriate illustrations. Fortunately, few second-to-die products have this design.

Another possible drawback of blending is that it may limit the flexibility to reduce premiums after purchase. If you buy 100% whole life and use dividends to buy paid-up additions, you can reduce the premium later by changing the dividend option or by surrendering accumulated additions. With a blended design, the company may require that dividends and paid-up additions be used to reduce the term component. This restriction varies by product, so you should investigate the mechanics of reducing the premium.

One danger of using blending to pay a premium that is significantly below a whole life premium is that you may be unable to increase the premium to a more conservative level later without evidence of insurability. If you wait for the company to determine that the policy is underfunded and to give you an opportunity to pay a higher premium or to reduce the amount of term insurance, the required premium may be very high. This won't be a problem if the company has a good early warning system, but some companies let you walk right up to the precipice before they say anything.

For all products, blending will turn out badly if the insurer later jacks up the term rates while leaving the whole life dividend mortality rates unchanged. Product repricing is governed by actuarial standards of practice, however, and this action would not stand up to scrutiny.

Before 1995, some commentators wondered if blending could have the adverse tax consequence of creating a modified endowment contract, because the seven-pay premium might be determined with respect to only the base amount, rather than the entire amount of coverage. That concern abated with the publication of three IRS private letter rulings (9513015, 9519023, 9741046).

When used in split-dollar arrangements, a blended design could result in a higher imputed economic benefit, if the actual cost of the term rider is used in place of the insurer's annual renewable term rates. Tax advisers disagree about how to compute the economic benefit for blended designs.

• **Limitations.** Insurers require a minimum percentage of whole life in the mix; 25% is typical. There is also a minimum whole life face amount; for example, \$100,000. Given these typical constraints, if you want a \$200,000 policy, you can't go below a 50/50 blend; if you want a \$1 million policy, you can't go below \$250,000 whole life.

Most universal life and variable universal life policies don't offer a term rider, so blending isn't possible. However, some companies do offer multiple versions of the same product, with different commission schedules and load structures.

Blending can be a powerful technique for turning a full-commission policy into a quasi-low-load. When clients understand how the process works, they rarely decide not to take advantage of it.

Glenn S. Daily is a fee-only insurance consultant in New York City. He can be reached at www.glenndaily.com.